Internal Revenue Service

memorandum

CC:TL
Br3:BGately

date: OCT 31 1988

to: District Counsel, Austin SW:AUS

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: Technical Advice
[redacted]

This is in response to your request for technical advice dated August 9, 1988.

ISSUE

Whether, under the circumstances described below, the taxpayer made adequate "disclosure of relevant facts" so as to avoid the addition to tax under § 6661.

FACTS

Taxpayer is an attorney certified as a taxation specialist by the Texas Board of Legal Certification. He filed his income tax return for the [redacted] taxable year on [redacted] 1/ This return reported an income tax liability of [redacted] and requested a refund of $[redacted]. Taxpayer attached Schedule D to his return. He identified on this Schedule D the sale of a capital asset not related to a tax shelter, and set forth the dates of acquisition and sale of the asset, its basis and the amount of gain. We assume this information was true and correct. The return did not have attached Form 6251, Alternative Minimum Tax Computation; there was no other computation or declaration of liability for the AMT.

1/ We assume, although it is not stated, that taxpayer had extensions of time to file his return and had paid in full by [redacted].

During the processing of this return, the Austin Service Center identified the existence of a capital gains preference item from the description of the sale on the Schedule D. Using the information shown on the return, the taxpayer's liability for the AMT was computed as $[redacted]. The Austin Service Center then prepared a notice of deficiency in the amount of $[redacted] and asserted the § 6661 addition in the amount of $[redacted]. No other additions or adjustments were asserted in this notice of deficiency, which was mailed [redacted].

Taxpayer timely petitioned the Tax Court and contested the entire determination. He now concedes his liability for the AMT; however, he argues he adequately disclosed the item on his return and is therefore not liable for the § 6661 addition.

LEGAL ANALYSIS

Section 6661(a) imposes an addition for a substantial understatement of income tax. For penalties assessed after October 21, 1986, the rate of the addition is 25%. Pallotini v. Commissioner, 90 T.C.___ (March 30, 1988).

A substantial understatement exists if the amount of the understatement exceeds the greater of 10% of the amount required to be shown on the return or $5,000. § 6661(b)(1). An understatement is the difference between the amount of tax required to be shown on the return for the taxable year and the amount of tax that is actually shown on the return (reduced by any rebate within the meaning of § 6211(b)(2)). § 6661(b)(2).

In the case of an item not attributable to a tax shelter, § 6661(b)(2)(B) provides that the amount of the understatement is reduced by the amount of the understatement attributable to any item if the taxpayer discloses, on the return or in an attachment, the identity and amount of the item as well as the specific facts or the position taken relevant to the tax treatment of the item.

Treasury Regulation § 1.6661-4 provides that disclosure may be made by a statement attached to the return or by providing sufficient information on the return. Treas. Reg. § 1.6661-4(c) provides, further, that the Commissioner, by Revenue Procedure, may prescribe "the circumstances in which information provided on the return" will constitute adequate disclosure. Rev. Proc. 85-19, 1985-1 C.B.520, does not list the AMT as one of the issues which can be disclosed by return.

The Tax Court, in Schirmer v. Commissioner, 89 T.C. 277 (1987) considered a claim of adequate disclosure in the context of farming issues. The Schirmers had attached schedules claiming farm losses, but the Government argued they lacked a profit motive. The Schirmers did not attach a statement of disclosure for purposes of § 6661 to their return. The forms on which they claimed farm losses were adequate disclosure, under the relevant Rev. Proc., only for a reserve for bad debts. The Tax Court held that under those accepted methods of disclosure, the taxpayers had not satisfied the statute. However, the Court went further:

> Where a taxpayer fails to comply with the Revenue Procedures issued in accordance with section 1.6661-4(c), Income Tax Reg., and fails to make specific reference to section 6661, the requirements of adequate disclosure on the return can nonetheless be satisfied by providing on the return sufficient information to enable respondent to identify the potential controversy involved. S. Rept. 97-494 at 274 (1982).

89 T.C. at 285-6. In a footnote, the Court also said:

> Sec. 6661 was added to the Internal Revenue Code by the Tax Equity and Fiscal Responsibility Act of 1982, Pub L. 97-248, 96 Stat. 324. The general explanation of this act, prepared by the Staff of the Joint Committee on Taxation, also lends support to our holding. The general explanation provides that the standard of disclosure under sec. 6661(a)(2)(B)(ii) requires "greater disclosure than is necessary to avoid the six-year statute of limitations provided for in section 6501(e)(1)(A)". Staff of Joint Comm. on Taxation, General Explanation of the Tax Equity and Fiscal Responsibility Act of 1982, at 218 (J.Comm. Print, 1982). The extended statute of limitations pursuant to sec. 6051(e)(1)(A) is triggered by the omission of more than 25 percent of the gross income stated in the return. Sec. 6501(e)(1)(A)(ii) states, however, that in "determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item." The disclosure required to trigger sec. 6501(e)(1)(A)(ii) and avoid application of the extended period of limitations provided by sec. 6501(e)(1)(A) has been held to require production of a 'clue' with respect to the omission of gross income. University County Club, Inc. v. Commissioner, 64 T.C. 460, 470 (1975), citing Colony, Inc. v. Commissioner, 357 U.S. 28 (1958).

89 T.C. at 286, fn. 7. Based on this reasoning the Tax Court held that the Schirmers had not adequately disclosed the profit-motive issue with respect to their farm activity.

The Tax Court has applied its Schirmer, supra, reasoning to other cases. In Gentry v. Commissioner, T.C. Memo. 1988-188, the Court held, citing Schirmer, supra, that the taxpayers had not provided enough information to enable the government to identify the controversy. The information provided was the name and identification of a partnership, and the amount of the claimed partnership loss. The issue was whether the claimed partnership transaction was devoid of economic substance. T.C. Memo. 1988-188, 55 TCM (CCH) 744. In Burwell v. Commissioner, 89 T.C. 580 (1987) Tax Court cited Schirmer, supra, in a footnote, and held the taxpayer liable for the § 6661 addition, on the grounds that his material misrepresentation of the relevant facts, as set forth on his return, was not adequate disclosure. 89 T.C. at 596.

The Tax Court's treatment of the Schirmer, supra, opinion strongly suggests that the Tax Court believes there are three tests for adequacy of disclosure, the statement test, the return/revenue procedure test, and the Schirmer test. The Schirmer test, that the return must contain enough facts to allow the Commissioner to identify the potential issue, is basically factual. The Court has said the taxpayer must give us more than a clue to the identity of the issue. When analyzing under this test, the Court's opinions have examined the issue in the case and the contents of the return, and have sought to determine whether the return leads to a clear identification of the issue.

In your case, we agree that the taxpayer could not prevail under the statement test or the return/revenue procedure test. But under the Schirmer test, for the Service to prevail it would have to argue that taxpayer's return did not enable us to clearly identify the issue. The return must have given the Service Center more than a clue to the identity of the issue, since it was able to identify the issue and make the adjustment from the figures on the return. Under these facts, in our opinion, the Tax Court would hold this taxpayer's disclosure adequate under Schirmer. We agree that the substantial understatement addition should be conceded in this case.

As the Schirmer test is primarily factual, we decline to speculate on the effect of the Schirmer analysis in other situations. We believe that, under these facts, the risk of loss of this case is sufficiently large to justify concession.

We also concur in the proposal to assert the addition for negligence. That addition, as far as we know the facts, seems much more appropriate. We anticipate that it would be sustained.

We have attached the opinion of the General Legal Services Division on the issue of conflict of interest which you also raised in your request.

CONCLUSION

We agree with your conclusion. We recognize you wish to concede the § 6661 addition and assert the negligence addition in its place. We agree that this would be the wisest course of action.

MARLENE GROSS

By: _____
SOMMERS T. BROWN
Acting Chief, Branch No. 3
Tax Litigation Division

Attachments:
Copy of GLS memo on conflict of interest question
Copy of request for advice